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BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF HAWAII

----In the Matter of ----	)	
	)	
PUBLIC UTILITIES COMMISSION	)	DOCKET NO. 05-0002
	)	
Instituting a Proceeding to Investigate the Issues and Requirements Raised by, and Contained in, Hawaii Revised Statutes 486H, as Amended.	)	

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POSITION STATEMENT OF

TESORO HAWAII CORPORATION

AND

CERTIFICATE OF SERVICE

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POSITION STATEMENT OF TESORO HAWAII CORPORATION

TESORO HAWAII CORPORATION ("Tesoro Hawaii") hereby respectfully submits its Position Statement pursuant to the requirements of Order No. 21670, filed March 1, 2005, as amended by Order No. 21822, filed May 16, 2005.

I. OVERVIEW

On September 1, 2005, the State of Hawaii, through Act 242,[1] will implement maximum pre-tax wholesale gasoline price caps that will impact all manufacturers, marketers, jobbers and other wholesalers of motor vehicle fuel throughout the State of

[1] Act 242, Session Laws of Hawaii 2004 ("Act 242"). The Act 242 provisions subject to the Commission's investigation have been codified under Hawaii Revised Statutes ("HRS") section 486H, primarily section 486H-13. Act 242 amended an earlier version of HRS Chapter 486H, Act 77, Session Laws of Hawaii 2002, that reflected Hawaii's initial attempt to place both retail and wholesale price caps on regular unleaded gasoline. Certain retail and other aspects of Act 77 have been removed from the current gas cap pricing law. Act 242, without further government intervention, will automatically take effect and will be the only law of its kind in the United States on September 1, 2005.

Hawaii. The legislative objective of Act 242 is "not to guarantee lower gasoline prices" but "to enhance the consumer welfare by fostering the opportunity for prices that reflect and correlate with competitive market conditions."[2] Unfortunately, neither Act 242 nor the ICF Report[3] recommendations have this effect. Quite to the contrary, price caps under either Act 242 or the ICF Report will not reflect or correlate with competitive market conditions and will fundamentally distort the free enterprise system in a broadly criticized short-sighted "experiment" to try and artificially control a single segment of a very small geographic portion of the global energy economy. Nothing good will result for any stakeholder -- business, government, consumer, public or private -- in the Hawaii energy community from Act 242.

II. TESORO HAWAII'S POSITION

Tesoro Hawaii opposes the imposition of any price control mechanism, including all of HRS § 486H-13 and all of the ICF Report. Price controls (e.g. price caps) of any type or design do not work and will create harmful market distortions that may increase the risks to Hawaii's consumers and economy, and may jeopardize the viability of Hawaii's refining industry. Further, wholesale gasoline price caps under either HRS § 486H-13 or the ICF Report are irreparable – there is no price index or geographic benchmark pricing market that will work better or worse than another since the entire approach is fundamentally flawed and unworkable.

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[2] Act 242, Preamble at 3.

[3] *Implementation Recommendations for Hawaii Revised Statutes Chapter 486H, Gasoline Price Cap Legislation*, ICF Consulting, LLC (April 15, 2005) (hereinafter referred to as "ICF Report").

Evaluation of Act 242 on Tesoro Hawaii

Tesoro Hawaii is very concerned about the risks of economic damage that the Act 242 may have on Hawaii. Tesoro Hawaii represents one of the few "value added" manufacturing successes in the State of Hawaii and its commitment to refine gasoline and other critical petroleum products (such as diesel fuel, jet fuel, fuel oil, naphtha, asphalt, liquefied petroleum gas, gasoline, and other blendstocks) is a critical component of the State's economic viability. Act 242 is a negative departure from the free market system that Tesoro Hawaii reasonably expected in making its original and ongoing investments in Hawaii.[4] These changes will undoubtedly be considered in future consideration of business alternatives in the State.[5]

This action is being accompanied by the April 2006 compliance requirements for ethanol.[6] Ethanol blending into gasoline is expected to generate additional capital requirements as well as manufacturing and operational issues for Tesoro Hawaii and the

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[4] Indeed, price caps by their very nature fail to recognize the significant capital investment (in the hundreds of millions of dollars) made by Tesoro Hawaii in its refinery operations in the State of Hawaii. Not only does this investment include the refinery, but also the significant cost of the off-shore mooring used to unload the crude oil from oil tankers, other marine transportation infrastructure and resources to ship the products between the islands of Hawaii, bulk storage terminals and many miles of pipelines to transport the crude oil as well as finished product between various facilities. Tesoro Hawaii's specific cost structure cannot be adequately compensated under price caps as the gasoline produced is comprised of local costs and expenses such as labor and available materials, and is just one of many petroleum products (such as diesel fuel, jet fuel, fuel oil, naphtha, asphalt, liquefied petroleum gas, gasoline, blendstocks and other petroleum products) that are produced and distributed, as it is impossible for a refiner to produce only gasoline from crude oil. The significant capital investment by Tesoro Hawaii, the need to handle the broad range of petroleum products in addition to gasoline that are produced from a single barrel of crude oil, as well as the use of local labor and materials, are all factors which are not specifically considered in price caps.

[5] ICF anticipates that Hawaii's refiners will "closely examine refinery profitability and sustainability" as a result of gas caps. ICF Report at 74.

[6] "ICF has concerns that the marketers, refiners, and consumers in Hawaii may be approaching a confluence of regulatory actions involving both the gas caps and ethanol which will likely create high business and capital investment uncertainty, as well as possible supply concerns." *ICF Consulting LLC Response to Tesoro Hawaii Corporation Information* Requests, Docket No. 05-0092 (June 17, 2005) ("ICF Responses to Tesoro") Tesoro-IR-28 at 29.

state. Further, there are no meaningful environmental benefits from ethanol for Hawaii given the climate, topography, and geography of the islands. The gasoline price cap law does not contain any allowance for the capital requirements of the ethanol mandate.

Exporting Product

Act 242 generates concerns with the negative implications affecting the refinery's capability to meet the needs of Hawaii's consumers. Negative impacts on refinery operations resulting from gasoline price caps have been widely recognized.[7]

Under normal market conditions, the production of petroleum products and by-products from the refinery are carefully balanced to ensure that a proper slate of petroleum products (such as diesel fuel, jet fuel, fuel oil, naphtha, asphalt, liquefied petroleum gas, gasoline, blendstocks and other petroleum products) are produced in a ratable fashion consistent with market needs and optimal refinery operation. This balance of products is vital as it is impossible for a refiner to economically produce only a single product, such as gasoline, from crude oil.

The normal market functions of supply and demand are displaced and distorted under a price cap. As a result, disruption of supply, inventory and the production chain is anticipated. Hawaii's gasoline price caps have the potential to undermine the rateable offtake of product from Tesoro Hawaii's refinery. Tesoro Hawaii will continue to balance its production with the market place alternatives both in and out of Hawaii. Price

[7] ICF Report at 74; Stillwater Associates, *Study of Fuel Prices and Legislative Initiatives for the State of Hawaii* 82 (Aug. 5, 2003) (hereinafter "Stillwater Study") at 149; NCSL Energy Program, *Findings on Hawaii Gasoline Prices and Policies* (Apr. 2003) ("NCSL") at 12.

controls may cause market shifts that are accompanied by changes and potential for local supply disruption and shortages.

III. PRICE CONTROLS DO NOT WORK

A. Experts Generally Oppose Price Controls As a Distortion of the Market

The Commission's consultant, ICF, provided the same advice as the Stillwater Associates analysis (Stillwater Study), by pointing out that the efforts in other jurisdictions to implement caps on gasoline prices have typically failed.[8] In response to a question from Tesoro Hawaii, ICF provided the following observations:

> "The report [Stillwater Study]...discusses the results of controls in several markets, most notably Australia and Canada. Some of the effects seen include:
>
> a. Tendency to price at the cap
> b. Complex to administer
> c. Increased volatility in prices (due to link to markets which move daily)
> d. Shortages at times
> e. Propensity to 'game' the system due to price lags
>
> **It is likely some of the same issues will occur in Hawaii, in ICF's opinion.**"[9] (emphasis added.)

Economists and other petroleum industry and marketing experts generally oppose price controls as a distortion of the market. As part of Act 77,[10] the Legislature reserved funds for the Department of Business, Economic Development and Tourism ("DBEDT") to retain economists and petroleum industry pricing experts to study the Hawaii gasoline

[8] ICF Report at ii.
[9] ICF Responses to Tesoro, Tesoro-IR-58 d) and e) at 59-60.
[10] Note 1, *supra.*

market. These consultants advised the legislature in 2003 against the imposition of gasoline price caps.

The expert conclusions against implementation of price caps came in the form of one of Hawaii's most comprehensive studies of gasoline price caps prepared by Stillwater Associates for the Energy, Resources, and Technology Division of DBEDT. Numerous meetings were held with stakeholders in Hawaii's petroleum industry, such as refiners, jobbers, dealers, industrial consumers, and also government organizations, staff specialists and service providers. The Stillwater Study concluded that price caps were ill-advised citing the following:

- federal price controls implemented as part of nationwide petroleum price controls from 1971-1981 did not work, created shortages and long gasoline lines;
- an in-depth review of other price control initiatives failed to identify any clear benefits; and
- price controls project an anti-business image for Hawaii.[11]

The second study prepared for DBEDT pursuant to the direction of the Hawaii legislature in Act 77 was conducted by the National Conference of State Legislatures ("NCSL"), a bipartisan organization that serves the legislators and staffs of the states, commonwealths and territories of the United States. NCSL emphasized the following disadvantages of gasoline price caps in its report to DBEDT:

- Price caps rely heavily on a formula. That formula will inevitably affect the market and prices not only for gasoline, but also for other crude oil-based products in the state. A price cap may have unintended consequences.

[11] Stillwater Study at 1-5, 99, 149-155.

- Price caps rely on a benchmark that is not reflective of the Hawaii market, even if that benchmark is more appropriate than the West Coast price benchmark.[12]

- Price caps place the government, instead of industry in charge of prices, partially removing market forces from the picture. Government may or may not do a better job of setting prices in a way that both encourages continuing investment in the industry while holding prices to a fair level.

- Price caps will discourage new suppliers from entering the Hawaii market or may push refiners out of the Hawaii market.

- Price caps may, in some situations, lead to shortages.[13]

Also, in 2003 the Office of Policy Planning for the United States Federal Trade Commission reached a similar conclusion opposing gasoline price caps in Hawaii. In written testimony before a joint hearing of Hawaii House and Senate Committees, Jerry Ellig, Deputy Director for the Office stated:

> "Most economists and antitrust experts doubt that price controls are a viable mechanism to increase consumer welfare in markets where competition is possible, and we see no reason that competition is not possible in Hawaii's gasoline market. Historical experience demonstrates that price controls tend to create shortages, reduce quality, and generate other inefficiencies."[14]
>
> * * *
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> "A significant body of research and experience suggests that price controls have a poor record of improving consumer welfare in markets where competition is possible, and may in fact cause more harm than good in the long term."[15]

Simply stated, price controls do not work.

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[12] Tesoro Hawaii does not endorse either of the benchmarks in HRS § 486H-13 or propounded in the ICF Report.
[13] NCSL at 12.
[14] Jerry Ellig, Competition and the Effects of Price Controls in Hawaii's Gasoline Market (Jan. 28, 2003) at 5.
[15] Ellig, *supra*, at 7.

B. Wholesale Gasoline Prices Are Not the Cause of Higher Gasoline Prices at the Pump

ICF believes that wholesale gasoline price caps will not necessarily mean that Hawaii's consumers will see significant changes in gasoline prices at the pump. The reasons for this include:

- The wholesale Gas Caps affect wholesale prices only. While there is a good deal of competitiveness at the retail (street price) level in Hawaii, it must be recognized that retail marketers are under no obligation to lower street price if wholesale prices are reduced.

- Hawaii's location places a premium on product prices. Wholesale product prices need to be high enough to cover the cost of freight and source gasoline price.

- Due to logistics, geography, and scale, the cost to supply the zones outside Oahu can be high (in some cases significantly).

- Hawaii's gasoline taxes are among the highest in the United States, averaging about 57 cents per gallon ("cpg") Federal, State, and City taxes. The US average is 44 cpg, so Hawaii consumers pay about 13 cpg above the United States average.[16]

Thus, while retail gasoline prices in Hawaii are higher on average than typical mainland cities, the differential between Hawaii and mainland cities can nevertheless be explained. The Stillwater Study reached a similar conclusion to that of ICF. The reasons for price differentials include the following:

- high taxes
- higher cost of living
- higher cost of doing business
- higher intrinsic cost of refining operations
- higher internal distribution cost[17]

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[16] ICF Report, *supra*, at 6.
[17] Stillwater Study, *supra*, at 89.

In addition, lower sales volumes in Hawaii also contribute to higher gasoline prices in Hawaii.

It is critical to emphasize that the State's independent consultants have found Hawaii's wholesale gasoline market to be in fact competitive, contrary to the Legislature's findings in Act 242.[18] Moreover, contrary to public perception, these same independent consultants have also concluded that overall profitability of refiners is not excessive.[19]

C. Price Caps Compound the Negative Impact of Hawaii's Lease Rent Cap and Divorcement Requirements

The State's consultant NCSL and the Office of Policy Planning for the Federal Trade Commission agree that several features of Hawaii's state policy already tend to reduce retail supply and increase retail prices, including rent caps for stations operated by lessee-dealers ("lease rent caps") and a law restricting marketers' ability to open new company-operated stations near existing dealer-operated stations ("divorcement").[20] These considerations are further compounded by the difficultly to obtain fee-simple ownership of land in Hawaii which may reduce the incentive to invest in station facilities.[21]

With respect to divorcement,[22] the Stillwater Study states that the divorcement legislation has not brought any real benefits to Hawaii. Over time, divorcement has

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[18] Stillwater Associates, *Hawaii Fuel Studies-Public Information Briefing (September 8, 2003) at 6.*
[19] *Id.* at 9.
[20] Ellig, *supra*, at 2; NCSL, *supra*, at 15 (In a study that included Hawaii, a Federal Trade Commission Report from July 1999 concluded that divorcement laws raised the average price of regular, self-service gasoline by 2.7 cpg); Stillwater at 120 & 151.
[21] Ellig, *supra*, at 3.
[22] *See* HRS § 486H-10.4(b).

resulted in higher prices for consumers, lower resale values for marginal lessee dealerships, while it offers no real protection to those dealers other than preventing encroachment by company operated stations.[23] Furthermore, a National Bureau of Economic Research study found that company-operated stations can be the most efficient form of management of high-volume, low-service gasoline stations.[24]

With respect to lease rent caps,[25] the Office of Policy Planning and NCSL both recognize arguments and posit policy solutions that include the removal or repeal of lease rent caps. Rent controls would likely reduce the number and quality of gasoline stations, increase gasoline prices, and cause inconvenience to consumers who would have to travel farther to find gas stations.[26] Lease rent caps fail to address the fact that property in Hawaii is much more valuable than is recognized by the lease rent cap.[27]

The imposition of gasoline price caps will only serve to exacerbate the negative effect of Hawaii's divorcement and lease rent cap requirements as it further expands government control and compounds market distortions in the petroleum industry in Hawaii.

D. Hawaii's Image as "Anti-Business" Will Increase

The ICF Report, the Stillwater Study, and the NCSL findings consider the impact of gasoline price cap laws on the State's ability to attract and foster business. Each independently concludes that there is a notable risk that Hawaii will be perceived as a

[23] Stillwater at 151.
[24] Ellig, *supra,* at 4, citing Asher A. Blass and Dennis W. Carlton, "The Choice of Organizational Form in Gasoline Retailing and the Cost of Laws that Limit that Choice," 44 *J.L.& Econ.* 511 (2001).
[25] *See* HRS § 486H-10.4(c); *see also Lingle v. Chevron U.S.A.,*No. 04-163, slip op. (May 23, 2005).
[26] Ellig, *supra,* at 4.
[27] NCSL, *supra,* at 15.

state with an "anti-business" climate because of its pricing regulation.[28] In particular, the Stillwater Study notes that an anti-business image for Hawaii is detrimental to the investment climate in general and, as previously discussed, to specific investments in Hawaii's energy infrastructure.[29]

E. Wholesale Gasoline Price Caps Will Change Consumer and Supplier Behavior

The ICF Report portrays the fundamental changes that will take place once the gas caps are implemented.

> "It is inevitable that the existence of gas caps will alter the behavior of participants. Each participant in the Hawaii gasoline market will evaluate the ramifications of the gas cap on their business, and, when enacted, develop the best tactical strategies to maximize profits within the gas cap constraint."[30]

Logically, wholesale customer behavior will also change in response to the implementation of the price cap legislation. Wholesale prices will be known to the market prior to the beginning of each business week. This information, in conjunction with limited gasoline storage particularly on the neighbor islands, will lead to erratic buying at the wholesale level and potentially result in supply disruptions.

IV. WHOLESALE GASOLINE PRICE CONTROLS UNDER EITHER HRS § 486H-13 OR THE ICF REPORT ARE IRREPARABLE

As discussed below, wholesale gasoline price controls under either HRS § 486H-13 or the ICF Report are irreparable – there is no price index or geographic benchmark

[28] ICF Report, *supra,* at 76; Stillwater Study, *supra,* at 2; NCSL, *supra,* at 12.
[29] Stillwater Study, *supra,* at 2.
[30] ICF Report at 6.

pricing market that will work better or worse than another since the entire approach is badly flawed and unworkable.

A. Overarching Issues

There are at least two major problems that run through all of the factors in HRS § 486H-13 and the ICF Report recommendations. The first is the questionable notion that pricing from markets outside of Hawaii should be imposed on Hawaii. The second major problem that runs through all of the factors in HRS § 486H-13 and the ICF Report recommendations is the source of data used for the price cap formula.

1. Local Conditions Preclude the Mixing and Imposition of Various "Markets" From Outside of Hawaii

Tesoro Hawaii believes that local conditions in Hawaii preclude application of pricing from markets outside of Hawaii. Hawaii is unique. It does not make economic sense to impose conditions and pricing of "markets" in Los Angeles, New York, the U.S. Gulf Coast, the Caribbean or Singapore on Hawaii. Tying Hawaii to these national and international areas exposes Hawaii to all of the risks associated with these regions in an arbitrary and short-sighted manner. Unpredictable events, normally having nothing to do with Hawaii, affecting prices, supplies and inventory in these regions of the world will affect the prices for wholesale gasoline here in Hawaii.

These effects will be felt in Hawaii in as little as one week leading to price volatility in the market place with little reason other than that Hawaii's petroleum future has been artificially tied to international and national risks in places thousands and thousands of miles away. Conversely, when factors such as supply disruptions occur in

Hawaii where an upward price reaction is necessary to increase supply, the price cap mechanism ignores the local situation, and exposes the Hawaii market to supply shortages.

2. Sources for Pricing

The second major problem is the source of data. HRS § 486H-13 and the ICF Report rely upon published sources such as Oil Price Information Service (OPIS), Platts, and the US Energy Information Administration (EIA). Each of these services has different strengths and weaknesses. All are prone to be in error from time to time and subject to correction.

Hawaii's gas cap law under either the statutory or ICF provisions would require that prices be based on fallible sources. Such errors, corrected after the fact would be irremediable from the standpoint of all participants in the chain of production, sale, purchasing, and resale.

B. Baseline Price

HRS 486H-13(c) provides for a baseline price to be established by the Commission based upon OPIS. The default provisions in Act 242 call for a weekly average of Los Angeles, New York Harbor, and US Gulf Coast ("USGC") to be used. The ICF Report recommends use of the weekly average of USGC 87 Rd, less 1 cpg, and Singapore 92 Road On based on Platts.[31]

Both markers and formulas are unworkable and irreparable. Price caps under any formulation will lead to severe problems for the petroleum industry and the consumers it

[31] ICF Report at 65.

serves. From an operational view, there are significant differences in gasoline characteristics between these source areas and the gasoline produced by Tesoro Hawaii, that cannot be ignored. The differences can be found in octane, sulfur and benzene content.

The crude oil stocks used by the large refineries in these areas are different from those used in Hawaii by Tesoro Hawaii. Crude oil represents the single largest cost factor in Hawaii refining.[32] These crude oils often have to be brought to Hawaii from distant locations at substantial premiums, and the net effect is that on average, the crude oil costs for Hawaii refiners exceed those of refineries in California or other Pacific Rim locations.[33] In addition, Tesoro Hawaii's refinery has a complexity level that is well below many other refineries in the Pacific Rim.[34] While this lower complexity is appropriate given the limited market demand in Hawaii, and the unique nature of the local demand for non-gasoline transportation fuels and residual fuel oil, Tesoro Hawaii does not have a yield or margin structure that would allow it to compete directly with Singaporean or USGC/Caribbean suppliers.

In summary, the baseline formulas of HRS § 486H-13 and the ICF Report cannot reflect and correlate with competitive market conditions in Hawaii. Moreover, Hawaii will be vulnerable to international and national risks wholly unassociated with the wholesale marketplace that existed in Hawaii prior to imposition of gasoline price caps.

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[32] Stillwater Study, *supra,* at 35.
[33] Stillwater Study, *supra*, at 38.
[34] Stillwater Study, *supra*, at 37-38.

C. Location Adjustment

HRS § 486H-13(d) calls for a location price adjustment of 4 cpg. The ICF Report proposes to use instead a weekly average of Caribbean and Singapore freight estimates employing Platts and adjusting by an ICF formula.[35] Neither formula reflects nor correlates with competitive market conditions as contemplated in Act 242.

Movement of cargoes to Hawaii is complex. The mode of transport, size and type of ships, product mixes, docking and mooring, composition, and tonnage proposed does not reflect actual conditions in Hawaii. Moreover, refined gasoline product movement from the locations cited in the ICF Report and HRS 486H do not now arrive in Hawaii contributing to the artificial and impractical nature of the approach of this regulation.

Other problems common to both formulas are presented when one considers the lack of backhaul opportunities in Hawaii and the worldscale premiums that would need to be paid in such event. Suffice it to say that shippers could not be expected to charge a rate that reflects the assumed efficient use of shipping, given that the most realistic assumption is that these natural inefficiencies exist for ship borne movement to Hawaii. Virtually all petroleum shipping needs to return or proceed to the next port empty after off-loading cargoes in Hawaii. Likewise, the spot market pricing employed does not match the term basis of movements of cargoes to Hawaii; and availability and costs of adequate terminaling does not appear to have been taken into account by either formula.

The import parity concepts in the statute and the ICF Report ignore fundamental economic necessities of refining, shipping and terminaling gasoline such as financing

[35] ICF Report at 65.

considerations, administrative costs, inventory carrying costs on the vessel, inventory carrying costs in terminal storage, market premiums, market discounts and, soon, ethanol impacts. Taken as a whole, the formulas presented by HRS § 486H-13(d) and the ICF Report fail to reflect and correlate with competitive market conditions in Hawaii.

D. Marketing Margin

The marketing margin factor from HRS § 486H-13(e) is set at 18 cpg for all classes of trade. The ICF Report breaks marketing margins into Dealer Tankwagon ("DTW") (15 cpg); Rack (Branded (6.7 cpg) and Unbranded (9.7 cpg)); and bulk (1 cpg above import parity (baseline plus location adjustment)). ICF uses certain continental United States cities and published sources to draw pricing data which will be updated annually.[36]

Marketing margins are time-sensitive items in a fast-paced market economy. Tesoro Hawaii must be able to recoup its costs in an accurate and timely fashion in order to achieve satisfactory earnings in a very capital intensive business. The formulas put forth by ICF and by HRS § 486H will not respond in real time to the actual marketing costs experienced by the company. In the case of ICF's recommendations, the cost of recovery will always be an average cost – subject to a one year delay. In the case of HRS § 486H, the number is fixed and will not change to account for different marketing conditions or increases (decreases) in costs to Tesoro Hawaii. Both formulas do not take into account direct and allocated Hawaii-based marketing costs and both are equally

[36] ICF Report at 66.

unacceptable to Tesoro Hawaii in view of the fact that they cannot and do not reflect and correlate with competitive market conditions in Hawaii.

E. Midgrade and Premium Adjustments

HRS §§ 486H-13(f) & (g) provide for a midgrade adjustment of 5 cpg and premium adjustment of 9 cpg. The ICF Report proposes to base adjustments across the classes of trade: (1) Midgrade DTW at 6.5 cpg, Rack at 4.2 cpg, and Bulk at 2 cpg; and (2) Premium DTW at 9 cpg, Rack at 9 cpg, and Bulk at 6 cpg. With respect to DTW and Rack for both grades the prices are tied to certain arbitrarily selected mainland cities based on published reports. In the case of bulk sales, the sources are US Gulf Coast and Singapore differentials.[37]

The formulas for the statute and the ICF Report suffer from similar infirmities found in the marketing margins analysis above. Both formulas do not take into account Hawaii-based costs in a real-time fashion.

Additionally, there does not appear to have been any thought given in either HRS § 486H or the ICF Report to the actual usage of the different grades of gasoline by Hawaii consumers.

Because of Hawaii's unusually high use of premium grades of gasoline relative to the rest of the United States, the product mix at the manufacturer level is different.[38]

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[37] ICF Report at 67.

[38] In 2003, Hawaii remained about ten percentage points above the US in using a larger share of premium grade gasoline. Hawaii consumers generally chose about 62% of their sales at regular grade, while the average US consumer uses 73% regular. Interestingly enough, if enough people in Hawaii simply matched the US grade mix, by one calculation, Hawaii consumers would have received the same savings at the pump as they might have under the wholesale and retail price caps envisioned in Act 77. Stillwater Study, *supra*, at 65-66.

Accordingly, neither of the formulas put forth reflect and correlate with actual competitive market conditions in Hawaii.

F. Zone Price Adjustments

HRS §486H-13(h) divides the state into eight zones. The Commission is tasked to determine what zone adjustments are appropriate. ICF recommends that Hawaii suppliers input data on an annual basis covering applicable barge, terminaling and trucking costs to these zones.[39]

The cost for movement of gasoline across zones and to the neighbor islands is a complex task that is especially susceptible to local market conditions. Determining the costs to service a particular zone is an impracticable exercise when one tries to apply average industry costs to a market with variable costs of service. Applying average cost concepts means, among other things, that service providers to low volume and small delivery size areas, i.e., rural "mom and pop" retailers, would become especially vulnerable. As well, there are non-ratable demands in terminal supply that will increase barging, trucking and terminal costs.

Under the Oil Pollution Act of 1990, the Federal government has mandated double-hulled barges for fuel transport. Tesoro Hawaii will have to make substantial capital investments to comply with the law. However, under either HRS §486H or the ICF Report, large scale capital improvements may not be subject to timely and reasonable recovery through wholesale sales of gasoline. The costs associated with long term

[39] ICF Report at 68.

agreements and leases for terminaling, barging, and trucking would be similarly disregarded under gasoline price caps.

The zone pricing adjustments contemplated by the ICF Report is the only method known to be under consideration by the Commission. If the Commission or a party proposes another method or formula to be used for zone adjustments, Tesoro Hawaii believes that the parties should be given an opportunity to address the methodology and formula prior to implementation, but Tesoro Hawaii believes that any price cap formulation of a zone adjustment will still be flawed. The formula contemplated under the ICF Report and the unspecified adjustments under HRS § 486H-13(h) do not and cannot reflect and correlate with competitive market conditions in Hawaii.

V. IMPLEMENTATION CONCERNS

Implementation, maintenance and monitoring the system needed for mandatory gasoline price caps will be exceedingly difficult and expensive for the Commission and market participants. Tesoro Hawaii has significant reservations about the State's and participants' ability to perform in a gas cap environment.

Numerous legal obligations attach to the use of Tesoro Hawaii information, not the least of which will be the maintenance of confidentiality and reporting requirements consistent with Sarbanes-Oxley, securities and antitrust laws. It will be difficult for market participants to understand and trust that competitive information -- information that can be used to the party's detriment, trade-secrets, and other proprietary information -- will all be safely downloadable and securely maintained in a single "database."

The complexities of ensuring compliance and the possibility for inadvertent violations of the gas cap law are of concern. Due to the changing nature of baseline pricing, wholly unrelated to the competitive market in Hawaii, and possibilities for source errors under either formula, Tesoro Hawaii believes that the Hawaii gas cap law will be flawed from the start. Furthermore, there is not enough time, let alone trained personnel and adequate resources at the State for any portion of the price cap law to be implemented in a fair fashion by September 1, 2005.

Market participants need to recover the costs of compliance with Hawaii's new gas cap law. The costs of compliance are already proving to be significant. Yet there is no provision in the law that allows the participants to recover costs associated with the gas cap law. This is one more factor in addition to many others that will erode the participants' ability to earn a fair rate of return or to otherwise provide a sound investment vehicle to justify investment capital into Hawaii.

VI. CONCLUSION

In closing, Tesoro Hawaii's believes that the imposition of price caps by any mechanism will only serve to distort market forces and result in long-term negative impacts to the citizens and economy of Hawaii.

DATED: Honolulu, Hawaii, July 1, 2005.

Respectfully submitted:

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CERTIFICATE OF SERVICE

I hereby certify that I have this date served a copy of the foregoing Position Statement of Tesoro Hawaii Corporation upon the following parties, by causing a copy hereof to be mailed via U.S. Mail, postage prepaid, and properly addressed to each such party.

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